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Charitable Contribution Planning: Perils and Precautions

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The Back Forty

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Charitable Contribution Planning: Perils and Precautions

by William T. Hutton

In the netherworld of tax, "advance sheets"—privately published reports of recent cases, IRS rulings, regulatory developments, and so on—are the bane of the advisor's existence. Each week's advance sheets bring reports of ordinary American citizens who, in their role as taxpayers, made a wrong turn or two, and became the subject of judicial or administrative comment.

Many of their stories ("autopsies" as a friend in the trade calls them) fairly overflow with human interest attractions—to the disinterested reader, if not to the victim. They may also be instructive, because the paramount goals of tax planning are (1) to achieve the desired tax/financial result and (2) not to become A Case. The first of those objectives is pretty well understood. But the second deserves a moment's pause.

The taxpayer who prevails in a dispute with the IRS over a charitable contribution, or, for that matter, in any other tax dispute, is apt to be a good deal happier than the taxpayer who loses. But the road to administrative or judicial resolution of a tax case is usually long and rough. Consider, for example, the hypothetical case of Zane Sturdley, who made a gift of 400 undeveloped woodland acres to the Phosphate Brook Land Trust in 1982, which produced a charitable deduction of $200,000 and total tax benefits (i.e., income taxes saved on account of that deduction) of nearly $100,000. The IRS didn't quibble about Zane's appraisal, but raised an eyebrow over his retention of a lifetime right to use the property for Sunday afternoon picnics during the months of July and August. IRS disallowance of the deduction, in its entirety, was premised upon the finding that Zane

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Welcome to The Back Forty

The Back Forty, the newsletter of land conservation law, is the product of a ground-breaking project with a simple premise: people working in conservation need legal knowledge to save land.

Our intention is to put the tools of land conservation law in our readers' hands. We will provide information on the unique combination of subjects that make up conservation law, including tax law, real estate law, and estate planning. We will write about them in understandable terms, place them in context, and share our opinions about them.

The Land Conservation Law Institute, publisher of *The Back Forty*, brings together the practical experience of The Land Trust Alliance and the scholarship of the University of California, Hastings College of the Law. The Institute not only will provide useful, up-to-date information for conservationists, but will acquaint law students with the real world of land conservation.

Help us serve you by sending your comments, suggestions, and questions.

Kingsbury Browne, Executive Editor

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had conveyed only a partial interest in the property, and that the applicable statute did not accommodate retention of picnicking rights.

The Service's position was literally unassailable, but Zane was advised to assert, by a newly retained attorney expert in such matters, that the retained rights were merely "insubstantial," and that, based upon scant but applicable administrative precedents, the deduction should be allowed. The IRS auditing agent remained unmoved, and, after a series of negotiations, the matter advanced to the IRS Appeals Office in 1984. The appeals officer assigned to Zane's case was mildly sympathetic, and once apprised of Revenue Ruling 75-66, 1975-1 C.B. 85 (allowing as an insubstantial retention the right to train hunting dogs on trails over donated property), appeared inclined to allow the deduction. But after conferring with his supervisor, he informed Zane that he had no choice but to affirm the disallowance, on the ground that "picnicking privileges are qualitatively different from dog trails."

By now it was late 1985, and since Zane refused voluntarily to extend the three-year statute of limitations (which was due to expire on April 15, 1986), a statutory notice of deficiency was issued, asserting total liabilities, for tax deficiencies, interest, and negligence penalties of \$154,421.10. The deficiency notice required Zane to petition the Tax Court for a hearing within ninety days, which he instructed his attorney to do. (One of the distinct advantages of a Tax Court proceeding is that adjudication is achieved *prior* to payment of the tax alleged to be owed; in the Federal District Courts, payment of the asserted liability is the price of admission.)

By the time the Tax Court petition was filed, Zane had incurred nearly \$13,000 in legal fees, and his sleep was regularly disturbed by the specter of his attorney sitting in the driver's seat of a taxicab beside a giant meter that advanced in \$100 increments. In mid-1987, after one desultory conference with district counsel (the IRS lawyer assigned to the case), Zane was apprised of a May 1988 trial date, subsequently postponed at the government's request to January 1989. Despite heroic efforts by the Tax Court judge to force a settlement prior to trial, the passing years had calcified the positions of the adversaries, and settlement was unthinkable.

After a two-hour trial, Zane waited ten months for the issuance of the Tax Court decision, which came last November. When his attorney called to say that he had prevailed, Zane felt he had been granted a fiscal stay of execution. When the euphoria subsided, however, Zane computed that his legal bills of slightly over \$27,000 translated into a cost-per-picnic of about \$1,450.

Yes, Zane's case is hypothetical, but, sad to tell, these things can and do happen, and frequently on a considerably grander scale. And so, in the interest of cautionary planning, we serve up here a bouillabaisse of highly susceptible transactions, with a seasoning of precautions (or possible alternatives).

The threat of "dealer" status

In 1969, Congress was troubled by the realization that dealers in property (manufacturers, retailers, even artists, for that matter) could attain more favorable after-tax results from charitable donations than from outright sales. To illustrate, sale of a suburban lot with a tax basis (essentially, original cost plus the cost of any improvements) of \$1,000, then worth \$10,000, would yield a

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The purpose of the Land Conservation Law Institute is to advance practical scholarship in land conservation law. Its projects include in-depth research, policy analyses and proposals, continuing education, and information dissemination.

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return of only $3,700 after tax on the $9,000 gain, whereas a charitable contribution, at (then-allowed) full fair market value, would put $7,000 in the dealer's pocket. (Those results assume a 70% top marginal rate, which remained applicable until 1982.)

The legislative remedy was simple, if primitive—reduce the dealer's deduction to basis. And so, transposing our example to the present day, the dealer, were he so ill-advised as to make such a gift, would be limited to a $1,000 deduction, and a tax benefit (at a 28% Federal rate) of a mere $280.

All of that is mathematical preface to the inevitable and exceedingly common question: "What makes a dealer?" To which the cautious advisor will almost always answer: "It depends on a variety of circumstances." Unfortunately, the courts, to which we look for guidance on such definitional issues, have provided no litmus test, nor do they agree upon the importance of various relevant factors. In the real estate context, volume and frequency of transactions, relative importance to the taxpayer's economic situation, the means chosen to market properties, and several dozen other factors are apt to come into play.

In some cases the determination is easy. For example, Muldoon owns four Idaho properties, all maintained as active cattle ranches for several years. Aside from sales of a few of his own personal residences, he has engaged in no other real estate activity. Donation, bargain sale, or the conveyance of an easement over one of the Idaho ranch properties will surely not raise any contention of "dealer" status. At the other end of the spectrum, Bagley's donation of six acres of suburban property to a local land trust, subsequent to his subdivision and sale of an appurtenant 40-acre tract, will almost surely force reduction of the charitable contribution amount to Bagley's basis.

There are, of course, dozens of variations on the "dealer" theme that fall between the situations of Muldoon and Bagley. A cautious tax advisor is most apt to suggest that no favorable result can be predicted in those close cases, and, for all intents and purposes, that advice will terminate the charitable contribution negotiations. Never mind that the top marginal Federal rate is now 28%, as is the capital gain rate on investment property. A rule is a rule, however completely divorced from the policy that gave it birth.

In one fairly common situation involving dealer property, however, it may be possible to finesse the facts-and-circumstances inquiry entirely. By abandoning the charitable deduction and adding the cost of the "donated" property to the basis of land intended for development, salutary results may be attained.

Suppose, for example, that Bagley's intended conveyance of suburban property was precipitated by his failure to gain certain lot-line readjustments or zoning approvals necessary to facilitate development on an appurtenant parcel. Further, assume that the reluctance of the zoning authority to grant those approvals was based upon its desire to maintain a greenbelt between property already developed and a major thoroughfare. If Bagley's conveyance were contemplated—and indeed required—by the authority as a condition of its approval of the overall project, the cost of the so-called "dedicated" property could properly be considered a project cost, and capitalized as part of the tax basis of the lots to be sold.

The ability so to recover the basis of the greenbelt property as part of the total project cost, as lots are sold, will be small comfort to the developer who has a low basis in the dedicated property. But if the dealer's purchase of the entire undeveloped tract was a relatively recent event, capitalization as a project cost may produce as satisfying a tax result as would a contribution (or even better, were the contribution to be subject to deferral on account of applicable percentage limitations).

Bargain sales and tax realities

Where a landowner is unwilling or unable to make an outright contribution of property, the bargain purchase may be a sensible accommodation. The concept is simple—the property is conveyed to a land trust for a price demonstrably below its fair market value, and the transaction is considered, for tax purposes, as a part-gift, part-sale. The gift is generally measured by the difference between appraised value and the sale price, and the gain on the sale is computed by subtracting from the proceeds of sale such portion of the taxpayer's basis in the entire property as is allocated to the sale based upon relative sale and gift amounts.

To illustrate, Ike Rumford's sale of Sunbluff Ranch, appraised at $500,000, to the Bohatchie Land Trust for $300,000 will produce a $200,000 charitable contribution. If Ike's basis in the ranch is $250,000, $150,000 would be allocated to the sale, according to the ratio of sale price to donation (3:2) and the resulting capital gain would be $150,000 (sale price minus allocated basis).

Simple, what? And predictable as to the financial outcome (with the inevitable caution, of course, that the appraiser's opinion may not be embraced by the IRS). Yet two or three times a year, those who work in the bargain sale vineyard on behalf of acquiring nonprofits are apt to be asked to consider exotic hybrid transactions. Such suggestions generally come from taxpayers' advisors, who may be presumed to have experienced some sort of tax epiphany. In my experience, the most common manifestation runs something like this (using Ike's property as our springboard):

"Look, you guys are prepared to pay $300,000 for Sunbluff, but what we propose to do is sell you 40% of the ranch for $300,000, and give you the rest. It will all happen at the same time, and you'll end up with all the property for the same $300,000."

The subtext may not be entirely self-evident, but it probably has something to do with using the sale price on 40% of the ranch as appraisal evidence of value on the remainder, thus more than doubling the amount of the alleged charitable contribution.

A variation on this theme involves an attempt to circumvent the IRS appraisal requirements by constructing the transaction as a sale at full fair market value, with a contemporaneous cash donation from the seller to the nonprofit donee. Needless to say, the donee organization determined to acquire the subject property only at a significant bargain will be unwilling to proceed with such a rearrangement unless the "cash gift" is an inextricable part of the overall deal.

Note that in each of our model cases the land trust ends up with the desired property at the desired price, and so there may be some temptation for the organization to take a "so what?" attitude toward the seller's suggested rearrangements. But there issues from each situation a distinctly malodorous taint. And the taxpayer, or the participating creative advisor, ought to be apprised that the Internal Revenue Service is hardly bound to acquiesce in a tax result established through formalistic contrivances. A bargain sale is a bargain sale is a bargain sale. And each of the Sunbluff variations comes to the same thing—sale of the ranch for $300,000. To justify that rather obvious conclusion, the IRS is likely to attach one of several time-worn labels, such as "integrated transaction," "substance over form," or, if sufficiently piqued, "sham." Whatever the appellation, the diagnosis is predictable, and as you might suspect, the opportunity for friendly and collegial negotiations with the revenue agent may have been somewhat diminished.

Let's suppose, for all of those cautions, that the taxpayer insists on one of the contorted arrangements described. For the land trust, it is undeniably desirable to acquire the entire property at the agreed-upon bargain price, but complicity in the mischaracterization of a bargain sale (or, for that matter, of any other purchase or donative transaction) may have serious and enduring consequences for the land trust's reputation. Considerable judgment is required here. If the land trust has gone on record with the landowner as disapproving the subterfuge and suggesting that the Service will readily see through it, consummation of the deal according to the landowner's paperwork may be a responsible course of action. This kind of issue is what board members are unpaid to consider, upon advice of competent counsel.

Reversions and deed restrictions

Let us now consider the situation of the landowner who, concerned about permanent preservation of the subject property and/or certainty of tax benefits, adopts a belt-and-suspenders attitude toward tax planning. Ida Hooper, aged 91, proposes to donate a remainder interest in her farm to the Lesser Dutiful Land Trust. Given that Lesser Dutiful, established in 1989, has no significant track record, Ida, on advice of counsel, proposes to hedge the donation by imposing certain deed restrictions, proscribing subdivision, commercialization, etc. Lesser Dutiful is entirely willing to accept the gift as so limited, since its own conservation purposes are entirely consonant with the proposed restrictions.

It is the published position of the IRS, however, that burdening donated property with deed restrictions reduces the amount of the deduction (Rev. Rul. 85-99, 1985-2 C.B. 83). When the pertinent ruling was promulgated, some tax advisors thought it inconsistent with prior law or common sense or both, while others believed it merely reflected a sound and prevailing, but theretofore unpublished, administrative position. Whatever the theoretical merits of the former position, it is clear that the Service is not about to reverse itself, and the negotiating land trust may have to offer creative alternatives to deal with the demands of the super-cautious donor.

One such possibility involves the use of an independent conservation organization as the donee. National and regional organizations often play this role, accepting gift properties free of restrictions, and then, independently and subsequently, negotiating with the local land trust as to sensible and palatable use restrictions. Provided that the donee organization plays a truly independent role, and is free to negotiate the ultimate use restrictions, albeit with the non-binding desires and concerns of the landowner in mind, this arrangement seems entirely appropriate.

Another, somewhat more complicated, approach involves a perpetual division of ownership—a conservation easement, qualifying under the requirements of Section 170(h) of the Internal Revenue Code, conveyed to a "protector" organization, and the balance of property rights (the "fee") to the organization assuming management responsibilities. This too seems an entirely workable premise, although the implicit assumption—that the value of the easement plus the value of the easement-encumbered fee will equal the total value of the property before the division—should be subject to confirmation by appraiser's opinion.

Another protective device frequently suggested is the reversionary interest. For example, "Should the Property cease to be used for a demonstration organic garden featuring pole beans and zucchini, it shall revert to Grantor, her heirs or assigns." Such a clause is apt to be fatal to the intended donation, since, under applicable regulations, supported by ample case authority, if the possibility of the defeat of a charitable transfer is "more remote than negligible," the deduction must be denied. (That is not to say, of course, that the denial of the deduction would force a reversion of the property; the charitable contribution and its fundamental intentions may well be achieved, and the organic garden may thrive forever, but without the benefit of a tax-expenditure subsidy.) In some situations the courts have saved donors from their follies through a generous interpretation of the "remoteness" test, but the road to such a determination is long and painful, and the result far from certain. The reversion theme is also played occasionally where the donor is concerned about the attainment of a certain minimum level of tax benefits. In such a case the permanence of the conveyance might be conditioned upon "the Grantor's realization of the benefits attributable to a charitable contribution in an amount not less than 80% of the fair market value of the Property established by independent appraisal." However solid the appraisal, that language, in and of itself, is almost certain to defeat the deduction. Since the IRS has no aversion whatsoever to appraisal challenges, and since the IRS very often succeeds in reducing the asserted amount of a contribution, based upon contrary expert opinion, the *possibility* of a reduction, in an amount exceeding 20%, in virtually any given case is certainly more remote than negligible. And if so, endgame. (And note as well, if you care to paddle a few strokes further in this little backwater, that the IRS could assert lack of entitlement to the deduction, based upon the remoteness test, without ever alleging that the appraisal itself overstated the property's value. In that case, presumably, the landowner would be relieved of both property and tax benefits.)

Appraising

The Competent and the Careless

Hard values are needed for competent estate planning—"low-balling" values may ruin the best-conceived estate plan if, for example, the IRS successfully increases values for estate tax purposes, and assesses a tax deficiency that causes the sale of the land. Thorough, competent appraisals are standing up in court. Careless ones are not.

Whether the contents of an appraisal comply with the Income Tax Regulations is a legal as well as an appraisal question. Donor's counsel may no longer simply leave the appraisal to the appraiser and be assured of avoiding later charges of negligence. While only appraisers may appraise, the tax laws attempt to define what is a qualified appraisal and who is a qualified appraiser. Failure to meet any one of dozens of appraisal requirements set forth in section 1.170A-13(c) of the Income Tax Regulations may result in loss of the income tax deduction.

Section 1.170A-14(h)(3) of the Income Tax Regulations provides that the "amount of the deduction in the case of a charitable contribution of a perpetual conservation restriction covering a portion of the contiguous property owned by a donor and the donor's family ... is the difference between the fair market value of the entire contiguous parcel of property before and after the granting of the restriction." Having said what should happen in the case of contiguous parcels, the same section of the Regulations expands on that rule by saying: "If the granting of a perpetual conservation restriction after January 14, 1986, has the effect of increasing the value of any other property owned by the donor or a related person, the amount of the deduction for the conservation contribution shall be reduced by the amount of the increase in the value of the other property, *whether or not such property is contiguous*" (italics added).

Thus, the appraiser must examine all of the property of the donor and related persons for possible enhancement.

An appraiser's fee should not be paid by a donee land trust. The appraisal requirement is imposed on the donor and payment thus becomes the obligation of the donor. If the donee pays the donor's obligation, a gift turns into a bargain sale.

Some valuations, conservation easements, for example, may require two appraisers. An appraiser skilled in valuing land for development may not be skilled in determining the value of land after it is restricted—if, for example, the value is based on timber use. The appraiser must certify on the Appraisal Summary that he or she is qualified to make appraisals of the type of property being valued (that is, the restricted property).—*Kingsbury Browne*